CAL

TAX NETWORK

Newsletter of the Tax Procedure and Litigation Committee
Taxation Section of the State Bar
August 2002

Message From Our Chair
Abraham R. Brown

Time certainly does fly! Believe it or not, my term as Chair will end in just a couple of months. It's been a great experience, and I appreciate all of the ideas and help I got over the past year from our many Committee members. The Tax Procedure and Litigation Committee has historically been one of the strongest and most active committees of the California tax bar, and I am glad that our Committee has maintained that distinction in the 2001-2002 year. We are also fortunate that our Committee has a stellar couple of leaders to take over the reins. Ed Perry will be our next Chair, and Steve Richter will move up to 1st Vice Chair. A new 2nd Vice Chair will be elected at the Annual Meeting of the Tax Bars on Friday, November 1, 2002 in San Diego. Of course, a special thank you goes out to Dave Porter, our newsletter editor, who ensured that the Tax Network is interesting, informative, and on time every quarter.

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Minutes of the April 26th Meeting
By Abraham R. Brown

The Tax Procedure and Litigation Committee held its third meeting of the 2001-2002 year on April 26, 2002 at the offices of McDonough Holland & Allen in Sacramento. Committee Chair Abraham Brown and 22 Committee members attended the luncheon meeting. Our Committee discussed numerous "Hot Topics", including a discussion of the recent 9th Circuit decision in *In re Renovizer's, Inc.*, which held that California has a "clear and convincing" burden of proof for the state to establish civil fraud in tax cases. Congratulations to

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Civil Fraud in California
By David M. Kirsch

Most of the readers of this publication are aware that in most federal tax cases the IRS must prove fraud (see IRC § 6663) by clear and convincing evidence. Is there a similar rule for fraud under California tax fraud statues?

There are at least three California statutes prescribing penalties for civil tax fraud: Rev. & Tax Code § 19164 (income tax) (specifically incorporating Federal law, IRC § 6663), Rev. & Tax Code § 6485 (sales & use tax) and Unemployment Insurance Code §1128 (employment tax). Although each of these provisions has been in the statutes for many years, only one reported case has addressed the burden of proof requirement, and that was 50 years ago. *Marchica v. State Board of Equalization*, 107 C.A.2d 501 (2nd Dist. 1951), held that the Board of Equalization, in a sales tax case, was required to prove fraud by clear and convincing evidence.

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But before I hang up my hat, there are still plenty of items to cover and lots of work to do. Our next Committee meeting on August 16th in Oakland promises to be just as informative and lively as always. We have put together an excellent panel of speakers from the IRS to discuss the latest tax shelters and tax avoidance schemes being promoted. The IRS is aggressively going after these illegal schemes. Terry Antell (Territory Manager of Taxpayer Education and Communication), Dale Zusi (IRS Counsel) and Mark Lessler (Criminal Investigation) will tell us all about the new schemes being promoted, how the IRS discovers them, and what is being done to stop them. They will also discuss some of the procedures available for taxpayers to avoid or reduce criminal and civil penalties in these cases.

In addition to the panel of IRS speakers, we also have a number of "Hot Topics" to discuss at the August meeting, including:

- New Proposed IRS Fees for Offers in Compromise: what are they, how much will they cost the taxpayer, and which taxpayers will have to pay under the proposed fee structure?
- Never heard of a 10-year collection statute for FTB tax debts? A new bill introduced in the Assembly could establish a new statute of limitations.
- The long-awaited (or long-feared) bankruptcy reform bill is expected to become law very soon. What is the current status of the bill and what would it do to tax debts in bankruptcy?

MCLE credit will be provided. If you have not already sent me your RSVP for the August 16th meeting, please do so no later than Monday 12th via email at abebrown@pacbell.net. Seating is limited, so any RSVP received after August 12th is subject to seating availability.

In the next few weeks, you should be receiving the brochure and program information for the 2002 Annual Meeting of the California Tax Bars. This year's Annual Meeting will be held at the Loews Coronado Bay Resort in San Diego on November 1-3. Our first Committee meeting of the 2002-2003 year will be held on Friday, November 1st and we will again be sponsoring our annual dinner on Friday night. The Tax Procedure and Litigation Committee will also be presenting 5 of the approximately 30 programs:

- Sales Tax Markup Audits – Did I Really Make That Much Profit? (David Kirsch)
- Information Sharing Among Tax Agencies and Interstate Enforcement of Tax Debts (Ed Perry)
- Search Warrant Procedure (Steve Richter)
- Trouble in Tax Land: A Look at Tax Practitioner Ethics (Cathy Stahler)
- Case Law Developments in Due Process and Innocent Spouse (Basil Boutris)

Woody Rowland is organizing this year's Federal Procedural Roundtable for the Annual Meeting, and the Saturday Keynote Speaker at the Annual Meeting will be Nina Olson, National Taxpayer Advocate. These two events are always very interesting and well attended. There is another reason you'll want to attend the 2002 Annual Meeting as this year's V. Judson Klein award will be presented to long-time Tax Procedure and Litigation Committee member **Karen Hawkins**. Congratulations to Karen! Be sure to send in your Program registration early, and don't forget to sign up for our Committee dinner.

In addition to providing up-to-date information on federal and state tax procedure issues to our members, one of our Committee's goals has always been to provide input on important tax issues or procedural problems to the IRS and California tax agencies. As a member of the Tax Litigation and Procedure Committee, you have a unique opportunity to bring difficult or troublesome tax issues to the attention of the state and federal tax agencies. Your input or proposal reaches the tax agencies in various ways. For example, you can write a formal paper to be presented to the IRS and government officials in Washington, D.C. We are continuing to develop proposals for the next Washington Trip, so please let us know about any tax issues you would like to see addressed by the next delegation to Washington, D.C. If you are interested in writing or presenting one of the Washington Trip papers next spring, please send an email to Ed Perry.

You can also bring difficult issues to the attention of the tax agencies on a less formal basis. Cris O'Neall (State and Local Tax Committee) will be submitting questions to the Franchise Tax Board, State Board of Equalization and Employment Development Department as part of the annual Eagle's Lodge meeting. Bill Taggart will ask the IRS to address troublesome issues at the IRS Northern California Practitioner Panel. Questions may pertain to substantive or procedural issues, and they should provide some background on the issue and the specific concerns or problems being encountered by the practitioner. Please bring your written questions to our Committee meeting on August 16th, or email them to me by August 16th if you cannot attend the meeting. This is a great way to address problems you are encountering in your practice before the IRS or state tax agencies!

Again, I appreciate all of the help and input I received this past year from our active Committee members. It has been a truly rewarding experience serving as Chair of such a lively committee. It was a pleasure meeting members from across the state and encouraging new members to join us. I hope that more of you will get involved in our Committee's activities in the coming year.

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Committee member David Kirsch who represented the taxpayer and argued the case at the 9th Circuit Court of Appeal. David led a lively discussion about the burden of proof in civil tax cases in California. Other topics discussed by the Committee members were:

- A discussion of the bankruptcy bill that is still making its way through Congress, and may have the votes to be passed this year. The bill would significantly limit the options available for discharging taxes in bankruptcy, as well as curtail the use of Chapter 7 bankruptcies.

- An update on IRS Collections Due Process (CDP) cases making their way through the IRS appeals process and into U.S. Tax Court or federal district courts. Some recent decisions have been issued by the Tax Court addressing jurisdiction, the stay on collection activities pending the court's decision, and procedures for CDP cases in the Tax Court.

- IRS Installment Agreements and the various statutes of limitation that could affect the agreement.

- Various topics and suggestions that will be discussed with the U.S. Tax Court judges in Washington D.C. as part of the State Bar Tax Section's annual delegation to Washington D.C. in May. The discussion topics were assembled with the help of Committee members Stuart Hurwitz, Bill Taggart and Woody Rowland, as well as suggestions from other Committee members.

- Update on the Tax Court *pro bono* program in Northern California which is being organized this year by Bill Colgin at Fenwick and West

Two speakers from the Employment Development Department also attended the meeting to present a one hour MCLE program on EDD Settlements and Hearings. Kim Wesley, an EDD Settlements Officer with over 13 years of experience with the EDD, spoke about the EDD settlement process. She offered numerous tips for improving a taxpayer's settlement offer so that it is more likely to be accepted by the EDD. Beverly Spuhler, an EDD Hearing Specialist in the Sacramento Area Audit Office with 23 years of experience with the EDD, spoke to the Committee about the hearing process. Beverly discussed numerous "dos and don'ts" in preparing a taxpayer's EDD case for a hearing before an Administrative Law Judge.

This year's Washington Trip of the State Bar Tax Section will include two procedural topics to be presented to top officials at the Internal Revenue Service, the judges of the U.S. Tax Court, and legislative staff for the Senate Finance Committee and the House Way and Means Committee on May 13-14 in Washington D.C. Committee Chair Abraham Brown will be presenting his paper on "Administrative Relief From AMT Liabilities Arising From the Exercise of ISO's". Erin Collins of KPMG in Los Angeles will be presenting her paper on expanding the use of mediation for any IRS cases that are unresolved at the conclusion of an examination. Copies of the Washington Trip papers are available to all Committee members through e-mail. Contact Abraham Brown to request an electronic copy of the papers.

At the April Committee meeting, we also discussed the final programs to be proposed for this year's Meeting of the California Tax Bars being held in San Diego on November 1-3. Our Committee has proposed five programs for the Tax Bar Annual Meeting, as well as a procedural round table. The programs are being coordinated by Ed Perry (Vice Chair) with the help of program organizers and panelists Steve Richter (2nd Vice Chair), Cathy Stahler, Lavar Taylor, Basil Boutris, David Kirsch and Woody Rowland. Our Committee will also be presenting a program at the 2002 State Bar Annual Meeting to be held in Monterey on October 10-13. The program will be an overview of options available to challenge, settle or resolve IRS tax debts, and will be coordinated by Abraham Brown, Lavar Taylor and Judy Hamilton

The April 2002 issue of the Tax Network Newsletter was e-mailed to members in mid-April. Dave Porter, the Newsletter editor, put together an excellent newsletter, including an interesting review of recent tax opinions compiled by Rob Wood. If you did not receive a copy of the Newsletter but are a member of the Tax Litigation and Procedure Committee, please e-mail Dave Porter at porter@taxinstitute.com .

Our Committee will be meeting on the following additional dates this year:

August 16, 2002 in Oakland
November 1, 2002 in San Diego at the Annual Meeting of Tax Bars

(NOTE: These are the corrected dates – please mark your calendars!)

Our quarterly meetings are always well attended, they offer MCLE credit and lunch, and there is always a lively “Hot Topics” discussion which allows tax practitioners to exchange ideas and contacts on difficult tax controversy cases. Please feel free to contact our Committee officers (telephone numbers and e-mail addresses are listed at the end of the newsletter) with any questions about Committee activities or upcoming meetings, or to suggest speakers or topics for the meetings.

(Fraud from Page 1)

Since *Marchica*, the California State Board of Equalization (which is the state agency of last resort for both income and sales/use tax disputes) has consistently applied the clear and convincing standard in administrative rulings involving tax fraud. See e.g., *Appeal of Sherwood*, 65-SBE-046 (1965); *Appeal of Cal-Russ Construction Corporation*, 72-SBE-035 (1972); *Appeal of Wickman*, 1981 WL 11741 (1981); *Appeal of Adickes*, 90-SBE-012 (1990). Surprisingly, the California Unemployment Insurance Appeals Board – the agency of last resort for employment tax cases, including fraud cases – has never issued a precedent decision addressing the fraud standard of proof.

Given that the SBE applies the clear and convincing standard in reviewing agency determinations that come before it, it is not surprising that there is such a paucity of California caselaw on the subject. However, the dearth of caselaw would become a significant void if the issue were presented to a federal court, which is what happened to Renovizor’s, Inc.

Renovizor’s was an interior decorating and remodeling firm. The SBE audited some of its returns and assessed a fraud penalty. Renovizor’s filed a Chapter 11 petition, which was later converted to Chapter 7. The SBE filed a claim in the bankruptcy and Renovizor’s objected to the claim, both as to the tax determination and as to the fraud penalty assessment. With respect to the fraud issue, the bankruptcy court held that the preponderance standard applied, not the clear and convincing evidence standard. The court relied principally on *Liodas v. Sahadi*, 19 C. 3d 278 (1977), in which the California Supreme Court held that the preponderance standard generally applies to proof of civil fraud, pursuant to Evidence Code § 115 (which provides that “[e]xcept as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence.”) (Emphasis added). Applying that standard, the court upheld the fraud assessment. Renovizor’s appealed to the United States District Court, which affirmed the bankruptcy court. Renovizor’s then appealed to the Ninth Circuit.

Recognizing that the case presented an important but unsettled issue of state law, the Ninth Circuit certified the question to the California

Supreme Court, which declined to hear the case. This required the Ninth Circuit to decide that issue of state law.

The Ninth Circuit, in *In re Renovizor's, Inc. (California State Board of Equalization v. Renovizor's, Inc.*), 282 F.3d 1233 (9th Cir. 2002), discussed that *Liodas* involved civil fraud that was not tax fraud, whereas *Marchica*_was a lower court case specifically involving tax fraud. The Court ultimately concluded that *Liodas* did not overrule *Marchica*, because "it explicitly allows for differing rules in some fraud cases if other law specifically provides otherwise." 282 F.3d at 1239 (citing *Liodas*, 562 P.2d at 323). The Court also noted that California administrative practice had continued to apply the clear and convincing standard after *Liodas*. The sum of these authorities led the Court to conclude that California law on the applicable burden of proof was unsettled. Because the California Supreme Court had declined to review this issue, the Ninth Circuit had to resolve it. Noting the principle that the determination of applicable standards of proof "reflects the weight of the private and public interests affected as well as a societal judgment about how the risk of error should be distributed between the parties," 282 F.3d at 1240 (citing *Cynthia D. v. Superior Court*, 851 P.2d at 1311 (1993)), the Court held that for purposes of proving tax fraud in California, the state must prove fraud by clear and convincing evidence.

So, for the time being at least, state tax fraud cases that find their way into federal (most probably bankruptcy) court will be governed by the clear and convincing evidence standard announced in *Renovizor's*. Although *Renovizor's* involved sales tax, there is no reason to expect that a different rule would apply to income or employment tax fraud.
Further, as far as the author has been able to determine, the SBE continues to apply the clear and convincing evidence standard in administrative tax fraud proceedings. However, although *Renovizor's* is persuasively written, it cannot be predicted whether a state court would follow it, so the rule that would be applied in state court tax fraud proceedings – if any should occur – will likely remain unknown unless and until the California Supreme Court resolves the issue.

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Fior D'Italia: One Reason To Watch Your Stipulation Of Facts

By Jonathan R. Flora

There is a lesson about entering into stipulations in the Supreme Court's recent decision in *United States v. Fior D'Italia, Inc.*, __ U.S.__, 122 S.Ct. 2117; *on remand*, __F.3d.__, 2002 WL 1493340 (9th Cir. July 15, 2002). In that case, the Court approved of the IRS's use of an aggregate estimate in calculating tip income to assess a deficiency against a San Francisco restaurant. A significant portion of the Court's decision turned on stipulations made by the taxpayer.

Calculating Tip Income
Because tips are considered "wages" for purposes of FICA, a restaurant must report and pay FICA taxes on tips received by its waiters. § 3121(q) (section references are to the Internal Revenue Code of 1986, as amended). Employees are required to report the amount of tips they receive to the restaurant, and the restaurant must then calculate FICA taxes to the extent of tips reported to it. Treas. Regs. § 31.6011(a)-1(a).

In 1991 and 1992, Fior D'Italia, Inc. ("Fior") reported and paid FICA taxes based on amounts reported to it by employees. The same reporting forms showed that the restaurant's credit card customers alone paid in tips over $100,000 more each year than the amount the employees reported. These reports, not surprisingly, led to a compliance check.

To prove the amount of tips actually paid in the relevant tax years, the IRS used what it called an "aggregate estimation" method. It determined the average percentage tipped by credit cards customers for the year, and it multiplied the percentage by the restaurant's total receipts. As a result, the IRS assessed a deficiency against Fior using this amount. *Id.* at 2121-22.

Theories and Stipulations

Fior brought a refund action. It argued the code does not authorize the IRS to use an "aggregate estimation" method. Fior based its argument on a snazzy linguistic analysis of the FICA statutes. FICA defines wages in terms of tips received by individual employees, not by a group of them. The "wages" definition includes tips "received by *an* employee in the course of *his* employment." § 3121(q). Thus, Fior argued, the IRS can only assess a FICA deficiency by calculating tip income employee by employee. *Id.* at 2123.

Armed with this theory, Fior agreed to "simplify" the case through stipulations. It conceded that "for purposes of this litigation," it would "not dispute the facts, estimates and/or determinations" that the IRS used as a basis for its calculations of aggregate unreported tip income. *Id.* at 2122.

The Outcome

On appeal to the Supreme Court, Fior's statutory argument bombed. The Court dismissed it in a single paragraph, ruling that the "linguistic argument makes too much out of too little." *Id.* at 2123.

The Court paid more attention to whether the "aggregate estimation" method is unlawful as a result of being unreasonable. *Id.* at 2124. Fior countered that the government's method overstated income in several ways: (i) there is a floor and ceiling on tip income imposed by law which the method ignores; (ii) customers who pay cash leave lower tips; (iii) some customers stiff waiters; (iv) some customers get cash back from credit card tips; and (v) some restaurants deduct the credit card fee from the tip before paying the waiter. *Id.* at 2124.

The Court refused to consider any of these points. Its reason? Fior already had conceded that the government's estimations were accurate. The Court would not hear a challenge to the reasonableness of a method which the restaurant previously had agreed resulted in an accurate amount. The Court noted: "Absent such a stipulation, a taxpayer would remain free to present evidence that an assessment is inaccurate in a particular case." *Id.* at 2125.

There are many reasons to stipulate to facts. But giving up an argument is a tall price to pay to "simplify" a case.

Jonathan R. Flora
Robert W. Wood, PC
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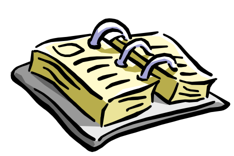
Reminder:



The Next Meeting is next Friday, August 16, 2002, in Oakland, California.

MORE ATTORNEYS' FEE CASES
By Robert W. Wood

The Tax Court recently decided yet another in the seemingly unending line of decisions concerning the tax treatment of attorneys' fees. In *Frank and Barbara Biehl v. Commissioner*, 118 T.C. No. 29, Tax Analysts *Doc. No. 2002-13103*, May 30, 2002, the Tax Court has held that amounts paid by a former employer to a former employee in a wrongful termination settlement fail to satisfy the business connection requirement of Section 62 and thus aren't part of an accountable plan, are includable in the taxpayer's gross income, and are treated as an itemized deduction.

Frank Biehl was an employee and shareholder of North Coast Medical Inc. (NCMI). Frank's wife, Barbara Biehl, was also an NCMI shareholder. In 1990 the Beihls entered into an agreement with NCMI and other shareholders, providing that in any suit brought for breach of the agreement, the prevailing party would be entitled to recover all costs of the suit, including attorney's fees. The agreement imposed restrictions on transfer of shares. In 1994 the couple filed an action in California court against NCMI. They hired Olimpia, Whelan, & Lively to represent them under a contingency fee for one- third of all sums recovered. The couple's action included claims for wrongful termination of Frank's employment and a claim for dissolution of NCMI. The claims were bifurcated, and a jury returned a $2.1 million verdict in favor of Frank on the termination claim. Without resolution of the other issue, the couple and NCMI entered into negotiations seeking a global settlement. In 1996 NCMI made two payments: $799,000 to Frank and $401,000 to the law firm. In 1997 the couple and NCMI signed an agreement and release of claims. The couple's NCMI dissolution claim was also settled.

NCMI issued Frank a 1996 Form 1099 for $1.2 million. The couple filed a motion in state court to enforce the agreement, alleging that NCMI violated it by issuing one Form 1099 rather than one to them and one to the law firm. The state court granted the motion. On the couple's 1997 tax return, they reported the $799,000 NCMI paid to Frank, but didn't report or disclose the payment to the law firm. The IRS issued a deficiency notice including the $401,000 in income. The IRS argued alternatively that if the $401,000 was income, the reimbursement was made under a nonaccountable plan and is included in income. The IRS determined a deficiency, primarily due to alternative minimum tax liability resulting from disallowance of the itemized deductions under Section 56(b)(1)(A)(I).

Tax Court Judge Renato Beghe noted that the fee was paid to the attorney under a reimbursement or other expense allowance arrangement under Section 62(a)(2)(A) and (C). The court concluded that the fees weren't paid under an employee reimbursement or expense allowance arrangement under Section 62(a)(2)(A) because they don't satisfy the business connection requirement. The court noted that Section 62(a)(2)(A) set out a business connection requirement for the expenses that is in contrast to the attributable to a trade or business requirement for business expense deductions for business owners. Specifically, the arrangement must be under an accountable plan, and Judge Beghe found that the attorney's fees in a wrongful termination suite against a former employer don't meet a requirement for an accountable plan because the business connection requirement of Section 62(a)(2)(A) is missing.

Judge Beghe noted that Frank's fees satisfy the threshold requirement of deductibility under Section 162(a) as a trade or business expense. The judge noted that in *Snow v. Commissioner*, 416 U.S. 500 (1974), the Supreme Court considered "in connection with" under Section 174(a)(1), compared it to Section 162(a), and found that the Section 162(a) language was narrower than the "in connection" language of Section 174(a)(1). However, Judge Beghe noted that the "connection" language is met only when the expenditure was integrated or integral to the business. The statute, regulations, cases, and legislative history compel a conclusion that fees incurred by a former employee aren't integral to the performance of services as an employee and fall outside the scope of "in connection with." The court noted that the expense must be incurred during a current employer-employee relationship and not a former relationship. The court noted the apparent injustice of the holding but concluded that it is the job of Congress to cure it.

What is most interesting about the *Biehl* case is the theory advanced for not reporting the attorneys' fees. Rather than relying on the ownership of the attorney (something rejected in *Kenseth* and a variety of other cases), the petitioners in *Biehl* did not report the $401,000 paid to their attorney based on the argument that the defendant made this payment pursuant to a "reimbursement or other expense allowance arrangement" under Section 62(a)(2)(A) of the Code. The idea was that this was a type of employee reimbursement, since the defendant in the case (as is so often the case on the attorneys' fee netting issue) was the former employer of the plaintiff/taxpayer.

The court, however, found that there was not a sufficient business connection between the reimbursement of the legal fees and the plan. Indeed, the Tax Court goes through a rather lengthy analysis of reimbursed expenses of employees, the requirements of Section 62 and of the regulations under it, and the difference between so-called "accountable" plans and "nonaccountable" plans. Ultimately, the Tax Court concludes that these legal fees, despite what I found to be appealing in this argument, just don't fit the bill.

One More Word

This does raise the question whether someone else might get more creative and do a better job of satisfying the requirements in Reg. 1.62-2(d)(2). The Tax Court tries to close this door, stating that the initial threshold requirement for an accountable plan that there be a "business connection" just isn't met. The Tax Court said that because the attorneys' fees paid to Mr. Biehl's lawyer did not satisfy the business connection requirement, it did not need to reach the question whether it satisfied the substantiation requirements set forth in the accountable plan regulations. Interestingly, it would seem that legal fees arising out of a suit against the employer would be the kind of thing that there should be an adequate business connection to. The Tax Court cited a Ninth Circuit case, *Shotgun Delivery, Inc. v. U.S.*, 269 F.3d 969 (9th Cir. 2001), for the proposition that this is a critical issue. The Tax Court does note that Mr. Biehl's attorneys' fee satisfies the threshold requirement for deductibility under Section 162(a). That, it turns out, also is necessary in order for an expense to qualify as being paid under an accountable plan. See I.R.C. 162(1); Reg. 1.62-2(d).

Of course, the last chapter on this attorneys' fee mess is still waiting to be written. The Supreme Court has denied cert. (not surprisingly) in the Tenth Circuit case, *Hukkannen-Campbell*. See *Nancy J. Hukkannen-Campbell v. Commissioner*, No. 00-9030 (10th Cir., Dec. 19, 2001), S.Ct. Dkt. No. 01-1348 (see *Tax Notes*, May 20, 2002, p. 1185). Do I think this attorneys' fee issue will be resolved anytime soon? Not hardly!

IS A SALE OR EXCHANGE REQUIRED TO GET CAPITAL GAINS?

One of the classic debates in many recoveries is whether the recovery constitutes ordinary income or capital gain. There are a fair number of cases that deal with this distinction for corporations. Currently, though, in the absence of a capital gain rate differential for C corporations, the class of taxpayers to which this ordinary income/capital gain dichotomy applies is somewhat smaller. Nevertheless, it is a fundamental issue that comes up across a whole bevy of types of litigation.

And, the incentives are pretty obvious. In the vast majority of cases, taxpayers want to argue for capital gain treatment, while the government (not surprisingly) nearly always is better off arguing ordinary income. It is up to the taxpayer to make the case for capital gain treatment. The question " apart from the usual origin of the claim type issues " is whether on top of everything else, the taxpayer needs to show that there was a sale or exchange in order to qualify for capital gain treatment. This issue has been a confusing one.

There is conflicting authority on the sale or exchange requirement. The Internal Revenue Service, the Tax Court (except as discussed below) and the Tenth Circuit have ruled that there must also be an underlying sale or exchange in order to qualify for capital gains treatment. In Revenue Ruling 74-251, 1974-1 C.B. 234 (1974), the Revenue Service ruled that acceptance of payments in settlement of claims in a lawsuit does not constitute a sale or exchange. The ruling states that:

> "[u]nless it can be clearly established that there has been a sale or exchange of property, money received in settlement of litigation is ordinary income. The mere settlement of a law suit does not in itself constitute a sale or exchange."

This ruling, however, involved a unique set of facts, and the rule is arguably limited by those facts. The Revenue Service's statement probably should not be read either to require a sale or exchange in every case and/or to negate a settlement constituting a sale or exchange in every case.

The Tax Court has explicitly required sale or exchange treatment, although the decisions typically arise when a taxpayer argues settlement of a lawsuit constitutes a sale or exchange. For example, in *Steele v. Commissioner*, T.C.Memo. 2002-113 (2002), the taxpayers through a series of transactions conveyed and then re-acquired interests in a lawsuit in connection with a business sale. When the lawsuit settled, the taxpayers treated the income as additional compensation from the stock sale and reported it as capital gain. In holding that the income was ordinary, the court noted:

> "[N]ot every gain growing out of a transaction concerning capital assets is allowed the benefits of the capital gains tax provision.

> Those are limited by definition to gains from 'the sale or exchange' of capital assets. A sale or exchange must be shown for a taxpayer to receive long-term capital gain treatment." (Citations omitted.)

Similarly, in *Nahey v. Commissioner*, 111 T.C. 256 (1998), a corporate taxpayer acquired pending lawsuits in the context of a asset acquisition. When the lawsuit settled, the taxpayer reported the settlement as long term capital gain (without allocating any basis to the claim). The Tax Court stated that "[a] sale or exchange is a prerequisite to the rendering of capital gain treatment." *Id.* at 262. It reasoned that since the taxpayer's rights vanished when the lawsuit settled, it could not have sold or exchanged anything. The court therefore held the settlement was ordinary income. *Id.* at 266. See also *Kempter v. Commissioner*, T.C. Memo. 1963-68 (1963). There, the Tax Court indicated that the burden of proof on the taxpayer in the settlement of a lawsuit over the ownership of an oil and gas lease was to show that the settlement constituted a sale or exchange under Section 1222 of an interest in the lease or a capital replacement. The court found that the settlement agreement reflected the extinguishment of an unrecognized claim against property and the settlement of a claim against income, neither of which was sufficient to support treating the recovery as a capital gain.

Similarly, the compromise settlement of amounts claimed for services rendered under a government construction contract was held by the Tenth Circuit in *Sanders v. Commissioner*, 225 F.2d 629 (10th Cir. 1955), cert. denied 350 U.S. 967 (1956), not to constitute a sale or exchange since the money would have been taxed as ordinary income for services rendered if it had been collected when it was originally due. The court noted that the character of the income is not changed regardless of the intervening time between performance of the services and recovery through a lawsuit or compromise settlement. In *Turzillo v. Commissioner*, however, the Sixth Circuit reversed the Tax Court's determination to find that the settlement and release of a suit relating to the contractual rights of a former employee to purchase stock in the employer corporation was a surrender of property rights in exchange for money, affording capital gains treatment since there was a sale or exchange.

In other decisions involving a clear injury to a distinct capital asset, however, the Tax Court has allowed capital gain treatment even when there was no sale or exchange and without even raising the issue. For example, in *Inco Electroenergy Corp. v. Commissioner*, TC Memo 1987-437 (1987), the taxpayer sued Exxon for infringing on one of its existing trademarks. Exxon agreed to pay the taxpayer $5 million in damages, and the taxpayer continued to use the trademark. In analyzing the origin of the claim, the court stated that "amounts received for injury or damage to capital assets are taxable as capital gains, whereas amounts received for lost profits are taxable as ordinary income."

The court first found that the claim was for damages to the trademark and associated goodwill. It then stated that "we need only to characterize the nature of these assets," which it found were capital assets. It therefore ruled that the award was taxable as capital gain. It did not mention a sale or exchange requirement.

Similarly, in *State Fish Corporation v. Commissioner*, 48 TC 465 (1967), the taxpayer purchased all the assets of a company including its goodwill. The seller violated a non-compete agreement, and the taxpayer sued claiming injury to its goodwill. Although there was no sale or exchange of the goodwill, the court ruled that the award constituted a tax free recovery of basis.

The IRS also has allowed return of basis and capital gain characterization when homes were injured even though there was no sale or exchange. For example, in Rev. Rul. 81-152, 1981-1 C.B. 433, a condominium management association recovered an award against a developer for defects in the units. No sale or exchange of a capital asset was involved. The IRS ruled that the award was received on behalf of individual unit owners. The ruling concludes that the proceeds represent "a return of capital to each unit owner to the extent the recovery does not exceed that owner's basis in his or her property interest in the condominium development." The ruling also notes that the unit owners must reduce their individual bases in the property by their share of the award.

Similarly, in Letter Ruling 9335019 (1993), a homeowners association brought a claim for damages against developers for construction defects. In analyzing the origin of the claim, the IRS ruled that the proceeds "represent amounts to repair or restore the property that the builder agreed would be properly constructed." As a consequence, the IRS held that the settlement payments "are not income to the unit owners, but instead represent a return of capital to each unit owner to the extent each unit owner's portion of the recovery does not exceed that owner's basis in his or her property interest." The IRS instructed the unit owners to reduce their bases by the amount of their share of the recovery.

In Letter Ruling 9343025 (1993), a homeowners association settled a claim against a developer and county for injury to common roads and land relating to housing developments. Although there was no sale or exchange of any capital asset, the IRS ruled that because the funds were intended to mitigate against expected damage to the developments, "the receipt of the settlement proceeds represents a return of capital to the Association's unit owners to the extent that each unit owner's portion of he recovery does not exceed that owner's basis in his or her property interest."

Recently, the Tax Court decided *Mark J. Steel, et al. v. Commissioner*, T.C. Memo 2002"113, *Tax Notes Doc. No. 2002-10804* (May 6, 2002). There, the court seemed to lay down a uniform rule that a sale or exchange is required for capital gains treatment. The court noted that the settlement there was ordinary income because resolution of a lawsuit is simply not a sale or exchange - even though the lawsuit in question was purchased in an acquisition! This seems an awfully narrow view.

The Tax Court has refused to construe two couples' receipt of settlement proceeds as capital gains from the sale of stock, finding instead that the funds were taxable as ordinary income.

General partners Mark Steel, Odd-Bjorn Huse, and Bjorn Nymark formed Bochica Partners to acquire the stock of Birting Fisheries Inc. (BFI). The men were the directors and shareholders of BFI, which bought an insurance policy on a commercial fishing vessel. BFI filed a lost-profits claim under the policy, and reported the partial insurance payment as ordinary income. A dispute arose, and BFI sued the insurer for the balance of its claim. BFI sold its stock to Norway Seafoods

A/S, and the partners consented to the assignment of BFI's lawsuit to Ottar Inc. for the benefit of themselves as Bochica's partners. Bochica used its entire basis to compute its gain from the BFI stock sale. Steel and Huse recognized gain from the sale as part of their distributive share from Bochica.

The insurer made a payment on the balance of the insurance claim, which was distributed to the general partners. The suit was later settled for $1.5 million. The Huses and the Steels reported their amounts as long-term capital gains on their individual tax returns. The IRS determined that the source of the proceeds from the insurance company was the settlement of the lawsuit and that the funds weren't received as part of a sale or exchange.

Tax Court Judge Robert P. Ruwe held that the settlement proceeds were ordinary income, not additional consideration from the sale of their stock. Thus, the couples received less favorable tax treatment of the funds they received. The court explained that the settlement of a lawsuit isn't a sale or exchange under Section 1222(3)'s provision on capital gains taxation. The court rejected the couples' argument that they received the lawsuit in exchange for their stock, finding instead that the agreement assigning the lawsuit from BFI to the partners contemplated a distribution of any lawsuit proceeds before the stock sale transaction. Thus, the court concluded that the form of the assignment was a distribution from BFI to the partners, not a transfer by Norway Seafoods to the partners for their stock. The court also rejected the couples' argument that the distribution and stock sale transaction should be integrated or characterized as interdependent. The court concluded that, while the two events were related, the distribution wasn't designed as a financing tool to allow for the stock sale.

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Notes from the Editor

Articles and comments for the next newsletter are requested and are being actively solicited. If you have material that would be informative and relevant to the members of the Tax Procedure and Litigation Committee, please contact me at (415)834-1800, or: porter@taxinstitute.com

Thank you to everyone who has contributed to the newsletter. The success of the newsletter depends on the members and their participation through the contribution of written materials.

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Editor: David B. Porter

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